

Message Text

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ACTION NEA-09

INFO OCT-01 ISO-00 CIAE-00 DODE-00 PM-03 H-01 INR-07 L-02

NSAE-00 NSC-05 PA-01 PRS-01 SP-02 SS-15 USIA-06

AID-05 COME-00 EB-07 FRB-03 TRSE-00 XMB-02 OPIC-03

CIEP-01 LAB-04 SIL-01 OMB-01 AGR-05 IO-10 SAM-01

SAB-01 ACDA-05 /102 W

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TO SECSTATE WASHDC 5834

C O N F I D E N T I A L TEL AVIV 1394

E.O. 11652: GDS

TAGS: EFIN, IS

SUBJ: COMPROMISE REACHED ON TAX INCREASES

REF: TEL AVIV 1192 AND 1251

1. AFTER INTENSE NEGOTIATIONS WITH HISTADRUT AND EMPLOYER ORGANIZATIONS, GOVERNMENT DECIDED MARCH 2 TO REDUCE SCOPE OF FEB 24 TAX PROPOSAL. PAYROLL TAX WILL BE REDUCED FROM PROPOSED 7.5 PERCENT TO 4 PERCENT, WITH IMPLEMENTATION DELAYED UNTIL APRIL 1. THIS TAX WILL BE ELIMINATED UPON IMPLEMENTATION OF VALUE ADDED TAX, WHICH GOVERNMENT PROMISES TO INTRODUCE BY OCTOBER 1. OTHER ELEMENTS IN COMPROMISE INCLUDE PROMISE TO INTRODUCE TAX REFORM BY JULY, STRONGER EFFORT TO REDUCE TAX EVASION, PROMISE TO EXEMPT CERTAIN ADDITIONAL CONSUMER ITEMS FROM NEW SALES TAX, AND ESTABLISHMENT OF INTER-MINISTERIAL COMMITTEE TO DEAL WITH POSSIBLE UNEMPLOYMENT.

2. SMALLER PAYROLL TAX WILL INCREASE PROJECTED DEFICIT IN NEXT YEAR'S BUDGET FROM IL 1.5 BILLION TO IL 2.15 BILLION. IN ANNOUNCING COMPROMISE, FINANCE MINISTER RABINOWITZ
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SAID THAT INCREASED TAXES HAD BEEN REQUESTED BECAUSE DEFENSE

SPENDING HAD RISEN BEYOND LEVEL ORIGINALLY PLANNED. LOWER PAYROLL TAX WOULD, OF COURSE, MEAN INCREASED DEFICIT FINANCING WITH HEIGHTENED INFLATIONARY IMPACT. HOWEVER, COMPROMISE WAS BEST THAT COULD BE ACHIEVED AND IT WAS NOW NECESSARY TO MOVE AHEAD WITH TAX REFORM LEGISLATION WHILE AT SAME TIME DOING EVERYTHING POSSIBLE TO KEEP GOVERNMENT SPENDING WITHIN BOUNDS.

3. COMMENT: FINANCE MINISTRY OFFICIALS ARE PLEASED WITH COMPROMISE. MINISTRY'S MAIN EFFORT WAS WITH HISTADRUT WHERE OBJECTIVE WAS TO AVOID ANY CHANGE IN EXISTING FREEZE ON WAGES AND COST OF LIVING ALLOWANCE AT THIS TIME. RABINOWITZ REPORTEDLY WAS "ELATED" WHEN HISTADRUT AGREED TO DROP ITS DEMAND FOR INCREASE IN WAGES AND COL, AS COMPENSATION FOR HIGHER TAXES, IN EXCHANGE FOR ELEMENTS IN COMPROMISE. IN FACT, WE UNDERSTAND THAT CERTAIN MEMBERS OF CABINET HAD BEEN OPPOSED TO PAYROLL TAX HIGHER THAN 4 PERCENT BUT HAD GONE ALONG WITH RABINOWITZ WITH TACIT UNDERSTANDING THAT LOWER TAX MIGHT BE NECESSARY TO GET HISTADRUT ON BOARD. (HISTADRUT REPORTEDLY WILL REVIEW PRICE INCREASES STEMMING FROM NEW TAXES AT END OF APRIL TO DETERMINE IF RISE IN COL IS WARRANTED.) MANUFACTURERS ASSOCIATION IS UNHAPPY ABOUT EVEN REDUCED PAYROLL TAX, AND DENIES IT EVER AGREED TO IT, BUT OFFICIALS OF TREASURY TELL US ASSOC HAS NO CHOICE BUT TO GO ALONG WITH GOVERNMENT'S DECISION.

4. REVISED TAX PROPOSAL SEEMS CERTAIN TO BE APPROVED BY KNESSET DESPITE CONTINUING SNIPING FROM EMPLOYERS AND LEFT-WING OF LABOR ALIGNMENT. ONE OF STRONGEST CRITICISMS, PARTICULARLY FROM PRESS, WAS THAT GOVERNMENT HAD SUFFERED DAMAGE TO ITS CREDIBILITY BY PROPOSING A MAJOR TAX INCREASE WITHOUT WARNING AND WHEN LABOR UNDERSTOOD THAT THERE WOULD BE NO FURTHER CHANGES IN WAGE/TAX PICTURE UNTIL MID-YEAR. WE BELIEVE, HOWEVER, THAT RABINOWITZ HAS HANDLED MATTER REASONABLY WELL IN CIRCUMSTANCES. A REAL TEST NOW WILL BE WHETHER HE CAN PUSH THROUGH MEANINGFUL TAX REFORM WITHIN NEXT FEW MONTHS. RABINOWITZ, WHO BELIEVES IN CONSENSUS POLITICS, MOVES CAUTIOUSLY, TESTING LEVEL OF BELT-TIGHTENING THAT PUBLIC WILL BEAR. ACUTELY AWARE OF PUBLIC RESISTENCE TO FURTHER TAXES, HE ALSO KNOWS THAT ADDITIONAL PRESSURES FOR GOVERNMENT SPENDING ARE LIKELY TO

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BE ENCOUNTERED THIS YEAR. TWO POSSIBILITIES MENTIONED BY FINANCE OFFICIALS ARE NEW DEFENSE CONSTRUCTION, IF PRESENT DEFENSE LINE IS GIVEN UP IN SINAI, AND SPENDING TO CREATE JOBS IF UNEMPLOYMENT DEVELOPS LATER IN YEAR. THEY FREELY ACKNOWLEDGE THAT IN GOI VIEW LARGER BUDGET DEFICITS WOULD BE NECESSARY AND EVEN JUSTIFIED IN EITHER EVENT.
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